Short Form Order

SUPREME COURT - STATE OF NEW YORK

I.A.S. PART 7 - SUFFOLK COUNTY

PRESENT:
WILLIAM B. REBOLINI
Justice

Lucio Noto and Joan Noto,

Plaintiffs,

-against-

The New York State Department of Taxation and Finance (Thomas H. Mattox, Commissioner),

Defendant.

Clerk of the Court

Index No.: 03392/2010

Motion Sequence No.: 004; MD
Motion Date: 10/16/13
Submitted: 11/13/13

Motion Sequence No.: 005; MG; CD
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Upon the following papers numbered 1 to 70 read upon these two motions for summary judgment: Notice of Motion and supporting papers, 1 - 47; Notice of Cross Motion and supporting papers, 50 - 68; Answering Affidavits and supporting papers, 48 - 49; Replying Affidavits and supporting papers, 69 - 70; it is

ORDERED that this motion by plaintiffs, Lucio Noto and Joan Noto, for an order awarding summary judgment in their favor against defendant, New York State Department of Taxation and Finance, is denied; and it is further

ORDERED that the separate motion by defendant, deemed herein to be a cross-motion, for an order awarding summary judgment in its favor against plaintiffs is granted, and the complaint is hereby dismissed.

Plaintiffs commenced these actions under Suffolk County index number 03392/10 and under Suffolk County index number 035246/10 seeking declaratory judgment pursuant to CPLR 3001 "finding that N.Y. Tax Law §605 (2007) is unconstitutional as applied to them." It is alleged in both complaints that the plaintiffs are domiciled in Greenwich, Connecticut, and that they also own a vacation home in East Hampton, Suffolk County, New York. Prior to the commencement of the earlier action, the New York State Department of Taxation and Finance (State) audited the personal income tax returns of plaintiffs for the tax year 2005 and preceding years. As to the 2005 tax year, the plaintiffs had claimed a credit on their return pursuant to Tax Law §620(a) for taxes paid to Connecticut on income realized from the exercise of certain stock options. By letter dated April 6, 2007, the State disallowed the tax credit on the ground that the income from the stock options was not derived from Connecticut within the meaning of Tax Law §620(a). Plaintiffs were thereafter advised by the State that they owed an additional $3,532,144 in taxes plus $338,846 in interest for the 2005 tax year. While plaintiffs paid the increase, they also submitted a claim for a refund which was rejected by the State by letter dated July 3, 2009.

In addition, plaintiffs commenced another action under Suffolk County index number 035246/10 challenging the taxation by New York in 2006 of income from the exercise of stock options, deferred compensation and other income. When plaintiffs filed their 2006 New York State income tax return they submitted a disclosure statement in which they asserted that they excluded income not derived from sources within New York, including the income from the exercise of stock options, the deferred compensation and other income, and contended that taxation of such income would fail the internal consistency test formulated by the Supreme Court in ***Container Corp. of America v Franchise Tax Board,*** 463 US 159, 103 SCt 2933, 77 LEd2d 545 (1983). Under the internal consistency test, the apportionment formula by which a state taxes income of a taxpayer "must be such that, if applied by every jurisdiction, it would result in no more than all of the [taxpayer's] income being taxed" (*see* ***Container Corp. of America v Franchise Tax Board,*** *supra* at 463 US 169). The State initiated an audit and ultimately advised plaintiffs that they owed $1,757,937 in taxes, plus $72,487 in interest and $299,933 in penalties for the 2006 tax year. Plaintiffs paid the deficiency and then filed a claim for a refund, which was denied by letter dated February 4, 2010.

By order of this Court dated May 3, 2011, the motion by defendant for an order pursuant to CPLR 3211(a)(2) and (7) dismissing the complaint pertaining to the 2005 tax year was denied. This Court rejected defendant's argument that dismissal was warranted on the ground that plaintiffs had failed to exhaust their administrative remedies. Noting that no issue of fact is involved in the controversy before this Court, this Court held that plaintiffs were not restricted to their administrative remedies because a declaratory judgment action may be used to challenge the applicability or constitutionality of a taxing statute without exhausting the administrative remedies that the taxing authority may provide (***National Merchandising Corp. v New York State Dept. of Taxation and Finance,*** 63 AD2d 785, 786, 404 NYS2d 1009 [3d Dept 1978], citing ***Matter of First Natl. City Bank v City of N.Y. Fin. Admin,*** 36 NY2d 87, 324 NE2d 861, 365 NYS2d 493 [1975]). New York

courts have generally recognized an exception to the exhaustion requirement where a party is challenging the constitutionality or the basic applicability of a statute or regulation (***Amazon.com, LLC v New York State Dept. of Taxation and Finance,*** 81 AD3d 183, 203, 913 NYS2d 129 [1st Dept 2010]). Similarly, by order of this Court dated March 30, 2011, the defendant's motion to dismiss the complaint pertaining to the 2006 tax year was denied as to those causes of action for declaratory judgment, but other causes of action seeking a refund of taxes, interest and penalties were dismissed for failure to exhaust administrative remedies.

By stipulation between counsel and order of this Court dated October 3, 2012, the two actions were consolidated for all purposes under index number 03392/10. The plaintiffs argue as to both 2005 and 2006 that their income that was not derived from services provided in New York State has been taxed twice in violation of the Commerce Clause of the United States Constitution. In applying Tax Law §605 to the plaintiffs by treating them as statutory residents of New York State, the plaintiffs are subject to tax on the same income by both Connecticut and New York. Plaintiffs seek a declaration that Tax Law §605 is unconstitutional as applied to them because they are subject to double taxation on their stock option income, deferred compensation income and investment income in violation of the Commerce Clause in the U.S. Constitution under the internal consistency test. It is also alleged that the State's method of taxation of income not earned or generated in New York violates the Commerce Clause under the external consistency test. Both plaintiffs and defendant now move separately for an order awarding summary judgment in their respective favors.

The law is well-established that summary judgment is a drastic remedy to be granted only when there is clearly no genuine issue of fact to be presented at trial (*see* ***Andre v Pomeroy,*** 35 NY2d 361, 362 NYS2d 131, 320 NE2d 853 [1974]; ***Benincasa v Garrubo,*** 141 AD2d 636, 529 NYS2d 797 [2d Dept 1988]). The function of the court in determining a motion for summary judgment is issue finding, not issue determination (***Pantote Big Alpha Foods, Inc. v Schefman,*** 121 AD2d 295, 503 NYS2d 58 [1st Dept 1986]). The courts have repeatedly held that in order to obtain summary judgment, movant must establish its claims or defenses sufficiently to warrant a court's directing judgment in its favor as a matter of law (*see* ***Gilbert Frank Corp. v Federal Insurance Co.,*** 70 NY2d 966, 525 NYS2d 793, 520 NE2d 512 [1988], citing ***Zuckerman v City of New York,*** 49 NY2d 557, 427 NYS2d 595, 404 NE2d 718 [1980]; ***Friends of Animals v. Associated Fur Mfrs.,*** 46 NY2d 1065, 416 NYS2d 790, 390 NE2d 298 [1979]). The party opposing the motion, on the other hand, must produce evidentiary proof in admissible form sufficient to require a trial of material questions of fact on which the opposing claim rests (*see* ***Gilbert Frank Corp. v Federal Insurance Co.,*** *supra*).

At the outset, it is noted that the motion by plaintiffs for an order granting summary judgment in their favor must be denied, as plaintiffs failed to include a complete set of the pleadings in support of the motion as required under CPLR 3212(b) (*see* ***Mieles v Tarar,*** 100 AD3d 719, 955 NYS2d 86 [2d Dept 2012]; *see also* ***Sendor v Chervin,*** 51 AD3d 1003, 857 NYS2d 500 [2d Dept 2008]).

Plaintiffs acknowledge in their complaint that they own a vacation home in New York State, that they spent more than 183 days in New York State and that for each year in issue they are statutory residents of New York State under Tax Law §605(b)(1)(B). Under that statute, a "resident individual" is defined as an individual "who is not domiciled in this state but maintains a permanent

place of abode in this state and spends in the aggregate more than one hundred eighty-three days of the taxable year in this state. . ." It is plaintiffs' claim that plaintiff Lucio Noto exercised certain stock options that he had been given as part of his compensation while employed by Mobil and by ExxonMobil in Virginia and in Texas before his retirement in 2001. It is also his allegation that $24,428,908, the income derived from exercising stock options in 2005, and $17,195,140, the income derived from exercising stock options in 2006, was taxed by both the state of Connecticut as well as the state of New York. In addition, plaintiff received deferred compensation income from Mobil in the amount of $1,809,923 in 2005 and in the amount of $1,636,702 in 2006, as well as deferred compensation from ExxonMobil in the amount of $14,544,865 in 2005 and in the amount of $2,594,498 in 2006, which was also taxed by both Connecticut as well as New York. Plaintiff also claims that in 2005 he earned income from partnerships and other activities in California, Michigan and Pennsylvania totaling $33,623, and that he paid tax to those states on the income obtained within their borders. In 2006 he earned income in California, Massachusetts, Michigan and Pennsylvania totaling $19,024, and that he paid tax to those states on the income obtained within their borders. It is plaintiffs' assertion that defendant improperly denied a credit for those tax payments pursuant to Tax Law §620(a).

Plaintiffs contend that the stock option income, deferred compensation income and other income not earned in New York State "constitute income earned in interstate commerce", and it is argued that the application of New York tax laws burdens interstate commerce by favoring individuals who live and work exclusively in New York over individuals, like the Notos, who are statutory residents of New York and who earn income in other states. It is also alleged that the State improperly failed to apply the accrual rule under Tax Law §639(b) to the Notos and that the deferred compensation income should have been excluded from New York taxable income. In addition, plaintiffs claim that they are entitled to a credit under Tax Law §620(a) for taxes paid on investment income in California, Massachusetts, Michigan and Pennsylvania.

Under Tax Law §612 the adjusted gross income of a "resident individual" in New York is his or her federal adjusted gross income, with some modifications that reduce federal adjusted gross income (*see* Tax Law §612[c]). Plaintiffs admit that the stock options and deferred compensation were not taxable at the time they were given to Lucio Noto. They also acknowledge that the income from the stock options and deferred compensation constituted part of their adjusted gross income, and that federal tax was imposed on the income that was realized in 2005 and 2006. They also acknowledge that neither the State of Virginia nor the State of Texas taxed such income, since the gain on stock options is realized at the time the options are exercised (*see* ***Michaelsen v New York State Tax Comm.,*** 67 NY2d 579, 496 NE2d 674, 505 NYS2d 585 [1986]). Since the income was included in their adjusted gross income, however, both the State of Connecticut, as the state in which plaintiffs are domiciled, and the State of New York, as the state in which plaintiffs are statutory residents, imposed taxes on the full amount of the income realized in 2005 and 2006. In addition, plaintiffs paid California tax in 2005 on California taxable income of $2,499 in the amount of $232, and they paid California tax in 2006 on California taxable income of $3,102 in the amount of $288. They paid Michigan tax in 2005 on Michigan taxable income of $30,914 in the amount of $1,206, and they paid Michigan tax in 2006 on Michigan taxable income of $13,660 in the amount of $533. Plaintiffs paid Pennsylvania tax in 2005 on Pennsylvania taxable income of $149 in the amount of $5, and they paid Pennsylvania tax in 2006 on Pennsylvania taxable income of $1,425 in the amount

of $44. In addition, plaintiffs paid Massachusetts tax in 2006 on Massachusetts taxable income in the amount of $332 in the amount of $35.

Under Tax Law §620(a), "[a] resident shall be allowed a credit against the tax otherwise due . . . for any income tax imposed for the taxable year by another state of the United States . . . upon income both derived therefrom and subject to tax under this article." Thus, the credit for income taxes paid to another state is not unlimited. The credit against ordinary tax is allowable only for that portion of the income tax imposed by another state which is applicable to the income derived from sources within such other state (*see* 20 NYCRR §120.1[a][2]). While residents of a state, including those who are domiciled in New York as well as those who are statutory residents, are generally subject to income tax based upon their worldwide income, New York provides a tax credit for income taxes paid by its residents to other states provided, however, that the tax imposed by the other state is on income derived or earned in that other state (*see* ***Tamagni v Tax Appeals Tribunal,*** 91 NY2d 530, 536, 695 NE2d 1125, 673 NYS2d 44 [1998]). Income derived from sources within another state is construed so as to include income from a business, trade or profession carried on in the other jurisdiction (*see* 20 NYCRR §120.4[d]). Accordingly, plaintiffs are not entitled to a credit against the tax paid to Connecticut since the income from the exercise of the stock options and deferred compensation was not derived from sources within Connecticut. Furthermore, the credit is not generally available for intangible income such as investment income, because that income has no identifiable situs (*see* ***Tamagni v Tax Appeals Tribunal,*** *supra* at 91 NY2d 536). Thus, under the rules promulgated by the State, "the resident credit is not allowed for tax imposed by another jurisdiction upon income from intangibles, except where such income is from property employed in a business, trade or profession carried on in the other jurisdiction" (20 NYCRR §120.4[d]). Where the taxpayer can show that intangible income is in fact derived from the taxpayer's activities in a state other than New York, such as where the income is derived from property employed in a business, trade or profession carried on in another state, the taxpayer is entitled to the credit (*see* ***Tamagni v Tax Appeals Tribunal,*** *supra at* 91 NY2d 536). While plaintiffs also submitted the initial pages of their non-resident tax returns for the tax years 2005 and 2006, plaintiffs did not submit any schedules or other forms, such as K-1 or 1099 forms, that were filed with their non-resident tax returns so as to identify the sources of such income. Only on the 2006 Massachusetts non-resident tax form is the income in issue identified as $48.00 in "Mass. bank interest" and $284.00 from "Rental, royalty and REMIC, partnership, S corp., trust income/loss." Based on the evidence before this Court, the plaintiffs failed to establish or to raise a triable issue of fact that the income which was subject to non-resident tax by other states was income derived from property employed in a business, trade or profession.

The Court of Appeals in ***Tamagni*** specifically rejected the challenge that Tax Law §605(b)(1)(B) subjects statutory residents to discriminatory double taxation in violation of the Commerce Clause, reasoning that the tax "does not operate to the disadvantage of any identifiable interstate market, but rather simply taxes residents based on their status as residents," and that it does not violate the dormant Commerce Clause (***Tamagni v Tax Appeals Tribunal,*** *supra* at 91 NY2d 540). Furthermore, in ***Tamagni*** the Court of Appeals specifically rejected many of the arguments that plaintiffs assert, including plaintiffs' claim that Tax Law §605 is discriminatory because it subjects plaintiffs to double taxation, as well as the claim that the statute as applied to statutory residents violates the dormant Commerce Clause. The Court of Appeals held that the provisions

of Tax Law Article 22 do not substantially affect interstate commerce and, therefore, the protections of the dormant Commerce Clause are not applicable (*see* ***Tamagni v Tax Appeals Tribunal,*** *supra* at 91 NY2d 532). Recognizing that taxes imposed on statutory residents as well as taxes imposed on domiciliaries are permissible, the Court in ***Tamagni*** held that the New York Tax on statutory residents does not violate the Commerce Clause, even though its effect is double taxation (*see* ***Tamagni v Tax Appeals Tribunal,*** *supra; see also* ***Zelinsky v Tax Appeals Tribunal,*** 1 NY3d 85, 801 NE2d 840, 769 NYS2d 464 [2003]).

To the extent that plaintiffs also challenge the applicability of Tax Law Article 22 on due process grounds, such claim is also insupportable. A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society (***State Tax Commission v Aldrich,*** 316 US 174, 178-179, 62 SCt 1008, 86 Led 1358 [1942], citing ***Wisconsin v J.C. Penney Co.,*** 311 US 435). Here, the acknowledged ownership of a vacation home in New York and the physical presence of the plaintiffs in New York for more than 183 days a year establishes the minimal connection that due process requires.

In view of the foregoing, the defendant State has demonstrated that plaintiffs' claims are not supportable under ruling case law, and that there are no triable issues of fact to warrant a trial. While plaintiffs may have been subject to tax on their income as residents of both the State of Connecticut and the State of New York, such taxation did not operate to the disadvantage of any identifiable interstate market nor did it violate the Commerce Clause or constitutional protections of due process. This Court has considered the plaintiffs' remaining contentions and finds them to be without merit. Accordingly, summary judgment in favor of the defendant is warranted.

Dated: 3/3/2014

William B Rebolini

HON. WILLIAM B. REBOLINI, J.S.C.

____X____ FINAL DISPOSITION_____ NON-FINAL DISPOSITION